Examiner's report

P7 Advanced Audit and Assurance
June 2010

General Comments
Despite covering some core syllabus areas, this paper proved challenging for many candidates. Overall performance continues to be unsatisfactory. Many candidates did not demonstrate awareness of the International Audit and Assurance Standards Board's (IAASB) Clarified ISAs, and generally the display of knowledge and application of that knowledge to the question scenarios provided was not at the standard expected in the final Professional Level examination.

The examination comprised two compulsory questions in Section A, and three questions in Section B of which two should be attempted. Both Section A questions were based on a case study, and contained several requirements covering different syllabus areas.

Each optional 20 mark question in Section B included a short scenario, and several requirements. Of the section B questions, question 4 the most popular, and roughly the same proportion of candidates attempted Question 3 and Question 5.

The vast majority of candidates attempted the correct number of questions, and there was less evidence of time pressure than seen in previous sessions.

The factors contributing to the poor pass rate for this sitting include:
- Failing to answer the specific question requirements
- Not applying knowledge to question scenarios
- Making too few comments given the mark allocation of a requirement
- Lack of knowledge on certain syllabus areas
- Illegible handwriting.
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The rest of this report contains a discussion of each question, highlighting the requirements that were answered well, and the areas that need improvement.

Specific Comments

Question One
This question was for 36 marks, and focussed on the planning of a group audit engagement. Requirements related to an evaluation of audit risk, reliance on the work of a component auditor, and audit procedures with respect to investments in associates and a grant received.

Overall performance on this question varied considerably. Candidates who answered the specific question requirements scored well. However, despite the requirements of (a) and (c) covering familiar issues seen in many previous papers, a significant proportion of candidates did not answer the specific question requirements, leading to largely irrelevant answers scoring very few marks.

Requirement (a) asked for an evaluation of principal audit risks, for 18 marks. Two professional marks were also available for the briefing notes required. The scenario provided plenty of indicators of potential audit risks, and many candidates produced sound answers which identified the risk and explained it in sufficient detail. Most candidates dealt well with the more obvious risks such as a profit-related bonus, a provision for decommissioning costs and the realignment of a foreign subsidiary's accounting policies. The majority of candidates managed to identify at least some of the audit risks specific to a group which acquired a foreign subsidiary during the year, and it was pleasing to see so many answers referring to goodwill, fair values, retranslation to group currency and alignment to group accounting policies. However, some of the explanations of audit risks identified were weak, amounting to little more than a statement of the correct accounting treatment, and not the risk to the auditor.
Many scripts contained the following errors:

- Discussion of business risk without linking the business risk to financial statement risk (e.g. 'there is a risk of failing to comply with relevant laws and regulations', or 'there is a risk that inventories are obsolete'),
- Including audit procedures (which were not asked for),
- Long description of the components of audit risk (inherent, control and detection risks) with no application to the scenario,
- Explanations too vague to earn marks (e.g. 'the risk is it is not accounted for properly' or 'the risk is that the accounting standard is not follwed'), and
- Discussing reliance on the component auditor (which the requirement explicitly said should not be considered).

Many candidates included the inevitable references to going concern problems, even though there was no hint in the scenario that the group faced operational or financial difficulties. Also, some candidates misread the scenario, leading to inappropriate comments. The most commonly seen example of this appeared in answers explaining that a change in accounting policy had occurred (the question stated 'changes in accounting estimates'). Candidates must read the scenario carefully to avoid this type of error.
Candidates who structured their answers under three heading of inherent risk, control risk and detection risk tended not to score very well. Those who worked through the scenario and discussed the audit risks associated with each of the group companies in turn, and then the audit risk of the consolidation process performed well.

A significant minority of candidates did not attempt to earn the 2 professional marks available for this requirement. Candidates are reminded that resources are available on ACCA's website providing guidance on the importance of professional marks.

The UK and Irish adapted papers featured a different presentation of the requirement for Q1 (a), the requirement being contained within the question scenario in an email from the audit engagement partner. Candidates dealt well with this different presentation of the requirement, which had been the subject of an examiner's article, and which will be introduced across all adaptations of P7 from June 2011.

Requirement (b) asked for an explanation of factors that should be considered and the procedures that should be performed in deciding the extent of reliance to the placed on the work of the component auditor, Sidle & Co. This was for 8 marks, and candidates were expected to demonstrate knowledge of ISA 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors),* which was revised and redrafted by the IAASB as part of the Clarity Project. Unfortunately it appeared that many candidates had very little, if any, specific knowledge of ISA 600, and produced answers which were vague and seemed to be based on guess-work rather than knowledge.

While most candidates could suggest that the principal auditor needed to gain some understanding of the level of competence and objectivity of the component auditor, few appreciated that it is a requirement of ISA 600 that the principal auditor shall obtain understanding of the regulatory environment in which the component auditor operates.

Procedures suggested tended to be based mainly on discussion, and many suggestions were impractical or unprofessional (e.g. 'ask Sidle & Co's other clients for a reference' or 'ask Sidle & Co to do a test to check their knowledge').

Overall performance on this requirement was unsatisfactory. Candidates are reminded that group audit engagements are an important part of the P7 syllabus, and the requirements and practical implications of the Clarified ISA 600 should be studied in detail.

Requirement (c) was for 8 marks and asked for principal audit procedures to be performed on the classification of non-controlling investments, and the condition attached to a grant received. Some candidates performed well here, providing procedures that were specific to the requirement and to the scenario. However there were three common problems with answers to this requirement:

- Suggesting procedures not specific to the requirement, i.e. procedures not relevant to <u>classification</u> of investments or specific to the <u>conditions</u> attached to the grant, (e.g. suggesting that the auditor should 'confirm the existence of the investments by visiting their head office').

- Suggesting procedures too vague to score credit, e.g. 'ensure the investment is classified correctly', or 'check the conditions of the grant have been met'.

- Discussion of the relevant accounting treatment – not asked for in this requirement.

Candidates are encouraged to read the examiner's article on exam technique in answering questions on audit procedures, published in September 2009 and available on ACCA's website.

Question Two
This question was for 24 marks, and featured a rapidly expanding private company, Mac Co, looking to improve its internal control environment through the outsourcing of its internal audit function, and potentially establishing an audit committee. A fraud had been recently discovered operating in the purchase system. The majority of candidates responded reasonable well to this question, though many answers did not reach their full potential by not being applied to the question scenario.

Requirement (a) asked for the benefits specific to Mac Co of outsourcing its internal audit function. A number of candidates performed well on this requirement, some achieving the maximum 6 marks. These candidates identified the benefits and explained the point with specific reference to Mac Co, as required. The candidates who failed to apply their comments to the question scenario did not perform well.

A significant number of candidates provided disadvantages of outsourcing the internal audit function – which was not asked for, and earned no marks. Candidates must read the requirement carefully to avoid this kind of mistake.

Requirement (b), for 4 marks, asked for the potential impacts on the external audit if the internal audit function were outsourced. Although some answers were sound, covering a range of potential impacts such as potential change to audit strategy, the need to document changes to systems and controls and the potential impact on the efficiency and cost of the audit. However the majority of answers were too brief and vague, simply saying that the external auditor would be able to place more reliance on internal controls, but failing to develop the answer beyond that observation.

Some candidates seemed very cynical of the role of internal auditor, implying that they may 'hide things' or 'refuse to co-operate'. Other candidates misread the question, and assumed that it would be the same firm providing the internal and external audit service, leading to irrelevant discussions about threats to independence and the need for separate teams.

Requirement (c) asked for procedures that could be used to quantify the loss suffered by Mac Co as a result of the fraud. On the whole, answers were unsatisfactory. Many candidates began their answer with an unnecessary description of forensic audit, while other wasted time suggesting controls that should have been in place to prevent the fraud from happening in the first place.

Some answers provided specific procedures, but few were good enough to score more than half of the 4 marks available. Some suggested procedures were unfortunately not practical and indicated that candidates should stop and think about the feasibility of a procedure before suggesting it, an example being 'ask the police how many invoices the fraudster has signed'. Very many candidates assumed that the investigator would have access to the fraudster's personal bank account. As in Q1 (c), many procedures were just too vague to earn credit, e.g. 'carry out an analysis of relevant documents' or 'use CAATs to find the amount'.

Requirement (d) asked for a report which compared the responsibilities of management and the external auditor in relation to the prevention and detection of fraud, and also for an assessment of the benefits and drawbacks of Mac Co establishing an audit committee. Each section of the report was for 4 marks, and 2 professional marks were available.

The section dealing with responsibilities in relation to fraud was generally well dealt with. Most candidates correctly identified that management and those charged with governance have the primary responsibility for the prevention and detection of fraud. It was pleasing to see many answers refer to the auditor needing to maintain an attitude of professional scepticism as required by ISA 240.

The section dealing with audit committees was less well answered, though most candidates managed to at least explain a couple of benefits of establishing a committee. Drawbacks were often not provided or were just one word answers e.g. 'costly' or 'bureaucratic'. The main problem with answers however was a lack of application to the question scenario – e.g. candidates seemed to forget that they were advising the directors of a company which had recently suffered a fraud and failed to point out that a stronger control environment which an audit committee would help to create would deter further frauds from occurring.

As in Q1 (a), some candidates did not attempt to earn the professional marks available.

Question Three

This question focussed on going concern issues and began with an 8 mark discussion in requirement (a). Candidates were asked to discuss firstly whether auditors should accept some of the blame when a company on which they have expressed an unmodified opinion subsequently fails, and secondly whether auditors should do more to highlight going concern problems. Very few answers were worthy of more than a few marks, most answers simply listing the auditors responsibilities from ISA 570 *Going Concern*, with no discussion at all of the statement provided in the question. Those who did refer to the statement provided tended to just state whether or not they agreed with it but provided no discussion at all. Answers were especially poor at discussing whether auditors should disclose more in relation to going concern, with most just describing the various ways that going concern issues may affect the audit opinion. It is inadequate that at this level of examination candidates seem simply unable to express an opinion of their own or base a reasoned discussion around a statement provided to them, especially around such a significant current issue facing the profession.

Requirement (b) contained a scenario describing an audit client, Juliet Co, facing going concern difficulties and attempting to overcome these difficulties by restructuring the business. The company had applied for a bank loan, without which significant doubt would arise over its ability to continue as a going concern.

Candidates were firstly asked in requirement (bi), for 6 marks, to identify and explain the matters that should be considered, and the principal audit procedures that should be performed in respect of the funding being sought. The main problem with answers were that they did not focus as required on the additional funding being sought, but instead discussed more generally the plight of the company. Some answers considered the difficulty that the auditor might face in attempting to gain evidence from the bank as to whether the loan would be forthcoming, and pointed out that the financial statements and forecasts carried high inherent risk of management bias as the directors would want to create as favourable a view as possible of the financial position of the company.

This requirement used standard wording that is seen in most exams (‘matters to be considered and audit procedures’), and an examiner’s article on exam technique has explained the best way to approach a requirement worded in this way. Candidates usually perform well on this type of requirement, so it is puzzling that this scenario failed to produce better answers, especially as going concern seems to be a popular topic with students.

In requirement (bii) candidates were asked to comment on the ethical and other implications of the company’s request for your firm to provide advice on forecasts and projections that had been asked for by the bank, and to attend a meeting with the bank at which the forecasts and projections would be discussed. This was for 6 marks, and was the best answered requirement of this question. Most candidates correctly identified and went on to explain the self-review, management and advocacy threats created by the situation, and many discussed the potential liability issue caused by attending the meeting.

Question Four

As usual, the ‘ethics question’ was the most popular of the optional questions. This question contained four brief ethical situations, from which candidates were required to identify and evaluate the ethical and other professional issues raised. Answers were mixed in quality – some were sound, but many did little more than identify threats but provided no discussion or evaluation of those threats identified.

Requirement (a), for 6 marks, described an audit client company, for which the audit firm had been asked to provide a valuation service in respect of a pension deficit recognised as a liability. On the whole this was well answered, with almost all candidates able to identify and explain the self-review threat and to suggest appropriate safeguards. Few candidates however considered the key issues of the materiality of the pension deficit to the financial statements, and the highly subjective nature of the valuation.

Requirement (b), for 6 marks, dealt with a situation in which Kia, the niece of an audit client’s financial controller had been specifically requested by the client to be included in the audit team. Again, most candidates could identify the familiarity threat to objectivity, though this was often not well explained, and most suggested that the best safeguard would be to exclude Kia from the audit team. Inevitably, many candidates wanted to see Kia disciplined for her ‘gross misconduct’ and reported immediately to ACCA.

Requirement (c), for 5 marks, described a custodial service that the audit firm was considering offering to audit clients. Most candidates identified the potential self-interest threat created but few could go further to evaluate the potential risk exposure to the firm or additional costs that may be incurred if such a service were offered.

Requirement (d), for 3 marks, explained that the audit firm had referred several clients to a third party for technical training, and would receive commission for the referrals. This situation was dealt with well, with most candidates able to identify and explain the threats and to suggest that full disclosure would be the best course of action.

On the whole this ethics question produced better answers than ethics questions in previous examinations. However, candidates’ performance is hampered by the fact that often only one ethical issue or threat per requirement is dealt with in their answers, which tend to be too brief for the marks available. Many candidates wrote the same amount for each requirement, despite the fact that requirements (a) and (b) were worth twice the marks of requirement (d).

Question Five

This question focussed in part (a) on the requirements of ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report*. This is an ISA which was revised and redrafted under the IAASB’s Clarity Project, and unfortunately many candidates did not seem aware of the new requirements. The requirement was for candidates to define an Emphasis of Matter (EOM) and an Other Matter (OM) paragraph and to provide examples of their use.

On the whole candidates dealt well with the EOM paragraph, usually giving a good definition and providing several examples of its use, the most common being in relation to going concern. Many candidates scored the maximum 6 marks for this part of the requirement.

OM paragraphs were not well understood by most candidates. Many incorrectly suggested that it should be used to explain a qualification of the auditor's opinion, and often no examples of its use were provided. Very few candidates scored more than half of the 4 marks available.

The UK and Irish adapted papers contained a different part (a), in which candidates were provided with a scenario describing an audit client's failure to adhere to its stated accounting policy regarding revenue recognition, and also the audit team's failure to obtain the evidence necessary in respect of property developments. The requirement was to explain and recommend further actions that should be taken by the audit partner, and to evaluate the potential impact on the auditor's report. On the whole, these requirements were dealt with reasonably well, with most candidates recommending appropriate actions such as discussion with management and those charged with governance, inspection of legal documents relating to the property sales, and alternative procedures to gather evidence on the property developments. The auditor's report was less well answered, with most candidates unable to do more than state 'disagreement' (old terminology for audit reports now not free from material misstatement is used) or 'limitation in scope'.

The second part of the question dealt with auditor's liability. Requirement (bi), for 4 marks, asked candidates to explain four methods that could be used by an audit firm to reduce risk exposure to litigation claims. On the whole this was answered quite well with a good proportion receiving maximum marks. However, some candidates failed to explain the methods, and just listed them out in bullet points, restricting the credit that could be awarded.

Requirement (bii), for 6 marks, asked candidates to assess the potential implications for the profession of audit firms signing a liability limitation agreement with their audit clients. Answers varied tremendously in quality here – some candidates discussed a range of issues in a reasonable amount of detail, while others produced only list of bullet points (e.g. 'poor quality', 'reputation suffers'). Most candidates could at least identify and briefly explain the issues of reduced public confidence and reduced quality of audit service provided.

Conclusion

This sitting highlighted the importance of application skills, as there was a significant difference in performance between those candidates who applied their knowledge to the question scenarios provided, and those that simply stated rote-learned facts in their answers in the belief that will be enough to pass the examination. In addition, as stated in previous examiner's reports, candidates must be willing to have an opinion of their own and be confident to tackle discussion questions.

A significant proportion of candidates continue to produce answers that are simply too vague or too brief, do not actually answer the question requirements, and display inadequate technical knowledge of the Clarified ISAs. These candidates are encouraged to improve their examination technique as well as knowledge of the syllabus by practicing as many past exam questions as possible, using up to date study materials, and by taking on board the comments made in examiner's articles and reports.